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Macroeconomic summary of the year

Reforms have stalled despite the accelerated economic growth in Ukraine this year. The government failed to take advantage of the favourable conditions in 2003 to drastically reform the public sector. The initiation of tax and pension reforms in early 2003 did not last into H2'03. We predict that in 2004, reforms will not accelerate either, because the government's resources and efforts will be diverted to the election campaign. In 2005, the new government will activate economic reforms, but the positive effect of these reforms will show a bit later. The environment will remain conducive to reforms in 2004–2005; economic growth will persist, though it will decline from 8% to 6%

Government failed to use all reform opportunities

The government of Ukraine failed to benefit from the favourable conditions in 2003—the economic upturn, advantageous foreign economic situation, and rapprochement with the EU, USA, and international organisations—and undertake profound reforms of the economy's public sector. Following a flurry of tax and pension reforms in H1'03, transformations took a slower pace:

- The system of insurance payments to social funds, which is one of the important factors driving the economy into the shadow, has remained unaltered;
- No viable mechanism to resolve the problem of VAT non-reimbursement to exporters has been developed so far;
- Tax benefits have not undergone any sizeable cuts;
- Protection of corporate and property rights has not been legislatively secured;
- The switch from benefits to targeted monetary assistance, as well as reforms in the housing and public utility sector, energy sector, and other monopoly entities, have never been initiated.

With the lack of new progress in reforming the economy, the government has even started to back down from what had already been achieved. Specifically, the 2004 budget does not envisage several important measures for reforming the pension system that were set forth in the new law on pension insurance. In addition, the 2003 state policy often led to tighter government pressure, which stymied private initiative. Notably, the Ukrzaliznytsia state railway corporation and the State Customs Service worked actively against the export of oil products, attempting to curb the price rises that negatively affected the government, and the Cabinet of Ministers obstructed exports of coke coal and scrap metal. In addition, the government and local administrations took the whole year to decide how to fix bread prices (and for what types) rather than pay more heed to conditions at the State Committee for Material Reserves or sign advance procurement contracts for grain imports to Ukraine.

In the meantime, continuing favourable external conditions, a stable financial situation, and the government's focus on privatising large-sized enterprises, as well as completion of commenced reforms give reason to hope for persisting high economic growth. In our opinion, the main problem in the work of the current coalition government is the lack of a coordinated reform plan, which reflects the divergence of economic views of government officials in charge of different sectors of the economy.

Economic dynamic assumed a brisker pace in 2003

The economic growth rate, which had dropped mid-year to 6% due to the sharp downturn in agriculture, accelerated towards the end of the year, and over January–November 2003 amounted to 7.7% in real terms. Growth factors, as previously, include the expansion of foreign trade and increased purchasing power domestically. Construction will continue to grow the most rapidly (25% is the annual estimate), which is connected to the investment activity of enterprises. The growth rate in industry accelerated to 15.5%, chiefly owing to growth in the food industry, machine building, the chemical industry, and metallurgy. We estimate that by the 2003 year-end results, GDP will grow by 8%.

Ukraine's foreign trade volumes increased sizeably. This was brought about not only by a rise in the exports of raw materials and semi-finished products, but by the high growth of machinery and equipment exports as well (according to our estimate, the 2003 growth rate will be 35%), particularly of vehicles (55%). Imports, in turn, grew not only owing to the high need for energy in thriving industry, but also due to larger exports of goods of investment demand.

The NBU reported that over the first nine months of 2003, merchandise exports picked by 26% y-o-y, while merchandise imports increased by 30%. Foreign trade in services also followed an upward trend, although at a slacker pace. Over January–September 2003, service exports increased by almost 13%, while imports thereof remained virtually unchanged. We predict that this trend will generally persist till the year end.

Lively exports fostered an even greater openness of the Ukrainian economy, with the export/GDP ratio reaching 60%. Therefore, the national economy is getting increasingly vulnerable to the external market situation. This entails two trends: (1) heightened risk of a fading economic dynamic if the situation in major export markets deteriorates; and (2) stimulated development of the domestic market.

On the demand side, accelerated investment was the most important factor in speeding up the economic growth from 4.8% last year to 8% this year. Our expectation is that the 2003 results will show a record-high growth of 20%. We believe that the key factors behind the increased investments are improved current financial status of enterprises and optimistic expectations for economic development in the years to come. Traditionally, enterprises' own money has been the main source of investment; that is why the increased corporate profits observed this year have dramatically expanded the investment opportunities of economic entities. However, a sectoral analysis of investments shows irregular and unstable investment activity. Investment in fixed assets are forging ahead in transport and communications, light industry, metallurgy, and machine building, while the chemical and pulp&paper sectors have even suffered cuts in investment. Such a dynamic signals that stable production capacity renewal trends remain out of reach and do not cover the entire economy.

In 2003, consumer demand grew by 10%; we consider the following to be key factors behind it: (1) increased personal incomes; (2) better economic expectations than last year; and (3) a more active usage of savings accumulated in previous years.

Macrofinancial stability persists, despite escalating inflation

The persisting financial stability has also been a reason for a strong economic dynamic. A high current account balance of payments (over 3 billion USD annually) has stimulated hard currency inflows to the country, thus stabilising the hryvnia exchange rate, which the National Bank virtually tied to the US dollar at 5.33 UAH/USD. In the meantime, in the light of the worldwide trend to a weakening dollar, as well as an escalated inflation rate in Ukraine's major trading partner—Russia—a perceptible hryvnia depreciation is taking place in real terms, which first of all is contributing to price competitiveness of Ukrainian exports.

Price and exchange rate stability has been facilitated by 100% replenishment of budget revenues, which enabled to fully finance the Consolidated Budget expenditures. However, for most of the year the government refrained from doing so, apparently considering it more expedient to accumulate funds to offset peak external payouts, and to raise minimum wages and pensions at the year-end. Again, state capital investments suffered from incomplete financing. This automatically diminishes the role of the public sector in the economy under the circumstances when private investments are advancing far more speedily. Underfinancing applies above all to local budgets; meanwhile, the execution level of expenditures of the general fund of the State Budget is almost 100% of the plan.

Over the year, the budget surplus has hit 2% of GDP and become one of the causes of a liquidity crisis in the inter-bank market, whose peak came in mid-November. Improved administration of budget revenues and higher industry and import growth rates compared to GDP pushed the share of GDP re-distribution via the budget up to 28%. A better execution of the revenues part compared to that of expenditures has to do with the accumulation of large sums of money on the State Treasury's account. We expect that the 2003 Consolidated Budget will be executed with a 0.2% GDP surplus.

For the most of the year, the inflationary dynamic was calm, as well. However, in autumn prices did begin to surge; we explain this burst of inflation largely by an increased production cost of flour, bread, and meat, due to the higher prices for imported grain, as well as partial price liberalisation for flour and baked goods during October–November 2003. Since the beginning of the year, prices on flour and baked goods have skyrocketed by 72% and 27%, respectively. In addition, price rises were also triggered by the overheating economy. According to preliminary estimates, consumer prices will have increased by 8.5% at YE'03.

In a bid to curb inflation and the demand for currency, the National Bank resorted to a tighter monetary policy. This led to a leveling-out of the demand-supply equilibrium in the inter-bank forex market, as well as dampened the lending rate. According to our estimate, in 2003 the growth rate of the banks' deposit base and of their credit portfolio will roughly equal 60%.

Challenges in 2004

We are pessimistic about the prospects for continuing reforms. According to our assumptions, the pro-government coalition will retain its power over the parliament and executive government till October 2004, with the composition of the coalition and the government majority remaining unchanged, though certain ministers are likely to be reshuffled. The quality and results of the state policy pursued by the current coalition still will not be high enough, and most reforms will be tabled at least until the election, because the government fails to understand their importance and also because of pressure from influential business groups. Such reforms may be initiated by the new president already in 2005, though their tempo and quality will depend on the personality of the new head of state.

We predict that government activity in 2004 will be aimed at stimulating final consumption and finalising the reforms already launched, rather than at investments and new unpopular reforms. This will help to retain the rather high GDP growth rate; however, it will no longer be supported by such a strong foreign economic situation as this year. Therefore, ICPS leaves unaltered its forecast for real GDP growth in 2004, at 6.5%.

A slower growth rate of real personal incomes at the end of 2003 will bring about a negligible decrease in consumption next year from 10% to 9%; at the same time, investment growth will stall perceptibly, sinking from 20% to 8%, which we attribute to the following: (1) the factor of the presidential election; (2) slowed export growth; and (3) decelerated bank lending to the economy ensuing from the accelerated inflation at this year-end and a tighter monetary policy.

In light of the presidential election, the government will stimulate final consumption and even increase budget expenditures up to 28.5% of GDP, in order to fully honour its social obligations. Cuts in the corporate profit and personal income tax rates will drive down budget revenues, from this year's 28% to 27% of GDP next year. However, the government will be able to finance the 1.5% deficit of GDP at the expense of foreign borrowings and privatisation. We expect the increased budget deficit to reanimate the market of domestic public borrowing.

We believe that the 2004 budget is an unsuccessful attempt at a compromise between long- and short-term government objectives, namely, reforms undertaken and increased social outlays prior to the presidential election. On the one hand, the document envisages a raise in the minimum wage and increased spending on subsidies and assistance. On the other, it still offers no solution to the problem of the quality of budget expenditures.

The focus on macrofinancial stability will persist. The price growth rate, in the light of a better harvest expected in 2004, will diminish to 6% y-o-y. The National Bank will continue to buoy a stable UAH/USD exchange rate. Sizeable foreign debt repayments and the risk of escalated inflation will impede the liberalisation of the financial sector, which is one of the key requirements of the World Trade Organisation. Our opinion is that the National Bank will only abolish sectoral restrictions right before the accession to the WTO in 2005.

In 2004, the major challenge of Ukraine's foreign economic policy will be the European Union's enlargement. This time, another ten countries will adopt the EU's common foreign economic policy, which will dramatically affect Ukrainian exports to these countries. In 2004–2005, Ukraine will also be missing out due to non-tariff restrictions, which will do away with the positive effect from the liberalisation of custom tariffs. According to our estimates, Ukraine's exports to candidate countries in 2004–2005 will shrink by 320–340 million USD annually.■

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